IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

ROESER & PENDLETON, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

THE OPINIONS OF THE COURTS BELOW

The opinion of the Board of Tax Appeals, denying petitioner the right to the statutory 27½% depletion allowance on the balance of $212,581.77, received by petitioner in the sale of its fractional interests in eleven oil and gas leases, wherein it reserved and retained one-half of its said fractional interests in the oil and gas in place, until it received therefrom $1,200,000.00, without charge for operation or production expense, is found in R. 95-105; see R. 102-103 for discussion of particular question here submitted.

The opinion of the Circuit Court of Appeals, Fifth Circuit, affirming the Board of Tax Appeals' decision upon the question here presented, is set out in R. 138-142; also in 18 F. (2d) 462. Inasmuch as the

Circuit Court of Appeals disposed of the question raised in this petition for certiorari, in one short paragraph of its opinion (R. 140-141), it is copied here in full:

> "The taxpayer contends that it should have been allowed statutory depletion of 27½% on the $212,581.77 of the cash payment received by it from the sale of its interest in the oil and gas leases. This contention is also without merit. The Board properly disallowed percentage depletion with respect to the cash payment received by the taxpayer. Commissioner v. Fleming, 82 F. (2d) 324; Laird v. Commissioner, 97 F. (2d) 730; Blankenship v. United States, 95 F. (2d) 507; Cf. Anderson v. Helvering, 310 U. S. 404."

ARGUMENT

After reading the above paragraph from the court's opinion, it is apparent that the Circuit Court of Appeals regarded the question, here raised, as settled by its previous decisions in the *Fleming Case*, 82 F. (2d) 324, and the *Laird Case*, 97 F. (2d) 730. It is true that the *Anderson Case*, 310 U. S. 404, is referred to in the Circuit Court's opinion, as supporting its view, but the Circuit Court in citing it, must not have analyzed or caught the force and effect of this court's holding, because it was one of the chief cases relied upon by petitioner, in the Circuit Court of Appeals, and, instead of upholding the Circuit Court's conclusions, previously expressed in the *Fleming*, 82 F. (2d) 324, and *Laird*, 97 F. (2d) 730 cases, it is, in reality, directly opposed to same.

Inasmuch as the opinion of the Fifth Circuit Court of Appeals in the *Laird Case*, 97 F. (2d) 730, consists of one paragraph in which the court approved, without discussion, on the authority of the *Fleming Case*, 82 F. (2d) 324, the action of the Board of Tax Appeals in denying to the taxpayer the right to claim depletion on a cash payment received in the sale of an oil and gas lease, where the seller retained a stated portion of the oil in place, until a stipulated amount of cash was realized herefrom, it is therefore unnecessary to further refer to the *Laird Case*, supra, inasmuch as the *Fleming Case*, supra, constitutes the "corner stone" of the Fifth Circuit Court of Appeals' unique holding.

Without going into a lengthy discussion of the reasoning of the Circuit Court of Appeals, in the *Fleming Case*, 82 F. (2d) 324, petitioner feels that the Circuit Court's conclusion that a lessee, who sells an oil and gas property, for a cash sum, retaining a specified interest in the oil and gas, in place, until the seller receives, from such retained interest, a designated sum of money, is not entitled to the statutory 27½% depletion allowance, is summarized in the following sentence taken from the Circuit Court's opinion:

> "The making of the sale depleted nothing. The money paid did not come actually or in anyone's contemplation, from the production of oil, but was the purchaser's independent capital invested by him in the oil lease." (82 F. (2d) at page 327).

In this single sentence is contained the truth or error of the logic, upon which is based the Circuit

Court's holding upon the question presented in this petition.

Petitioner says, and believes it can point out in a very simple illustration, that the reasoning of the Circuit Court, above set out is obviously erroneous. For instance, suppose petitioner had sold to the Atlantic Company its fractional interests in the eleven oil and gas leases in the East Texas field (eliminating from consideration the $187,418.23 of equipment and personal property included in the sale), for NO cash, but with the right, on petitioner's part, to receive from its retained interest in the oil and gas, in place, $1,412,581.77, without charge for production or operation expense, then, admittedly, petitioner would have been entitled to the statutory 27½% depletion allowance on the retained $1,412,581.77 of oil and gas, in place, as and when it was produced, because this court so held in the case of *Thomas v. Perkins*, 301 U. S. 655.

On the other hand, assume that Petitioner, instead of making the sale on the basis above outlined (no cash, but with a $1,412,581.77 retained interest in the oil and gas, in place, free of production or operation expense) elected to make the sale for $212,581.77 cash, with the right, on petitioner's part, to receive from its retained interest $1,200,000.00 without charge for production or operation expense, would petitioner, in this situation, be denied the statutory 27½% depletion allowance, which, admittedly it would have been entitled to, in the first instance where no cash was received, merely because, in the second instance, petitioner required the buyer to pay

$212,581.77 in cash, in anticipation of future production, which amount otherwise would have been paid to petitioner from the retained $1,412,581.77 interest in the oil and gas in place, as provided for in the first situation? Would the mere fact that petitioner received from the buyer $212,581.77 in cash, in anticipation of future production of the retained oil and gas in place, invalidate petitioner's right to the statutory 27½% depletion allowance on the cash received?

Expressed in another way, is the right of an owner of an oil and gas property to recover his invested capital in the oil and gas, in place, either actual or based upon discovery value, by claiming the benefit of the statutory 27½% depletion allowance, *dependent* upon the owner's operation and withdrawal of the oil and gas, in place? Or may the owner recover his invested capital, either actual or based upon discovery value, through the statutory 27½% depletion allowance, "by stipulating for a share of the oil produced from the discovered well, *through operation by another?*" (Quotation from *Palmer v. Bender*, 287 U. S. at p. 559).

The questions answer themselves. This Court, in *Palmer v. Bender*, 287 U. S. 551, said:

> "The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery, rather than at its original cost. The benefit of it accrues to the discoverer if he operates the well as owner or lessee, or if he leases it to another. *It would be an anomaly if that policy were to be defeated and all bene-*

fit of the depletion allowance withheld because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another.

"The bonus received by the Smitherman partnership was a return pro tanto of the petitioner's capital investment in the oil, in anticipation of its extraction, resulting in a corresponding diminution in the unit depletion allowance upon the royalty oil as produced." (Italics ours).

It is therefore apparent that the Fifth Circuit Court of Appeals has completely missed the point stressed by this Court in the above quotation from the opinion of this Court in *Palmer v. Bender*, 287 U. S. 551. The statement, in the opinion of the Fifth Circuit Court of Appeals, in the *Fleming Case*, 82 F. (2d) at page 327, that "the making of the sale depleted nothing; the money paid did not come actually, or in anyone's contemplation from the production of oil, but was the purchaser's independent capital invested by him in the oil lease" is, in a phrase attributed to the present Chief Justice of this Court, "*a tortured construction*" of the opinion of this Court in *Palmer v. Bender*, supra.

It is not, as stated by the Fifth Circuit Court of Appeals' opinion in the *Fleming Case*, 82 F. (2d) at page 327, a question who operates the lease and produces the oil and gas in place; or that the money paid by a purchaser to a seller of an oil property, did not come from the production of oil or gas, but represented the purchaser's independent capital, or that the making

of the sale depleted nothing; these matters are wholly beside the point. *The controlling principle is that the owner of an oil property has invested capital, either actual or based upon discovery value*, in the oil and gas, in place, which he is entitled to have *returned* to him through the medium of the statutory 27½% depletion allowance. It makes no difference whether such owner operates the property himself, contracts for others to do so for him, or sells the property, retaining an interest or share in the oil and gas in place, or as and when produced. In each and every instance, under the decision of this Court in *Palmer v. Bender*, 287 U. S. 551, the owner is entitled to the statutory 27½% depletion allowance. It is only through this medium that the owner's invested capital is *returned* to him. This is the substance of the holding of the United States Court of Claims in *Heep Oil Corp. v. United States*, 32 Fed. Supp. 762, decided May 6, 1940, which is in direct conflict with the holding of the Fifth Circuit Court in the *Fleming Case*, 82 F. (2d) 327.

Let us now review the decision of this Court in *Palmer v. Bender*, 287 U. S. 551, as stated in *Collector v. Perkins*, 301 U. S. 655, and explained in *Anderson v. Commissioner*, 310 U. S. 404, to determine if petitioner's views, above expressed, are sustained by the decisions of this Court, referred to.

In 1937, this Court, in the case of *Collector v. Perkins*, 301 U. S. 655, had occasion to review its opinion, rendered in *Palmer v. Bender*, supra, and with respect to same, said:

"The taxpayer, Palmer, was a member of a

partnership that acquired oil and gas leases, discovered oil, executed a writing conferring on a company the right to take over a part of the leased property in consideration of a present payment of a cash bonus and future payments to be made 'out of one-half of the first oil produced and saved' to the extent of $1,000,000, and an additional 'excess royalty' of one-eighth of all the oil produced and saved. The writing declared that the partnership 'does sell, assign, set over, transfer and deliver * * * unto the' oil company the described leased premises.

"In his tax return, Palmer reported his share of the income derived by the partnership from the bonus payment and oil received under its contract with the oil company and, relying on § 214 (a) (10), made a deduction for depletion based on value of oil in place on the date of discovery. The commissioner refused to allow the deduction on the theory that the transaction was a sale of the leases by the partnership, and that the only allowable deduction was one based upon the cost of the property. As cost was less than the discovery value, the commissioner's allowance of depletion was less than that claimed by Palmer and the tax was correspondingly greater. He paid it, and sued the collector to recover the amount by which the commissioner's ruling operated to increase his burden."

"The district court upheld the commissioner's ruling, the Circuit Court of Appeals affirmed, this Court reversed. We said (pp. 557-558): 'The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal re-

lationship, income derived from the extraction of the oil, to which he must look for a return of his capital. * * * Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. *It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so, he has an economic interest in the oil, in place, which is depleted by production.* Thus, we have recently held that the lessor is entitled to a depletion allowance *on bonus and royalties*, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. * * * Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom * * * were entitled to share in the oil produced.' (Italics ours).

"Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save to them an economic interest in the oil sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. *If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential.* The assignee was not entitled to income from Palmer's share of the oil nor to deduct from the income it received from its own interest any part of the depletion allowance that was attributable to Palmer's interest." (Italics ours).

We come now to the case of *Anderson v. Commissioner*, (310 U. S. 404), decided May 20, 1940, con-

taining the most recent expression by this Court upon the question under consideration, although the exact question was not there presented or decided. In the course of his opinion, Justice Murphy, speaking for the Supreme Court, said:

> "*It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable.* That issue is, who has a *capital investment in the oil and gas in place and what is the extent of his interest.* * * *
>
> "*Oil and gas reserves like other minerals in place, are recognized as wasting assets.* The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. Burnet v. Harmel, 287 U. S. 103, 106-107; Bankers Coal Co. v. Burnet, 287 U. S. 308; United States v. Biwabik Mining Co., 247 U. S. 116; Von Baumbach v. Sargent Land Co., 242 U. S. 503, 521, 522; Stratton's Independence v. Howbert, 231 U. S. 399, 414. The depletion effected by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. United States v. Ludey, 274 U. S. 295, 302-303; Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370. Compare Von Baumbach v. Sargent Land Co., supra, at 524-525. *The deduction* is therefore permitted as an act of grace and is intended as compensation for the *capital assets* consumed in the production of income through the severance of the minerals. Helvering v. Bankline Oil Co., 303 U. S. 362, 366-367. *The granting of an arbitrary deduction,* in the

interests of convenience, *of a percentage of the gross income* derived from the severance of oil and gas, merely emphasizes the underlying theory of the *allowance as a tax-free return of the capital* consumed in the production of gross income *through severance.* Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 321; United States v. Dakota-Montana Oil Co., 288 U. S. 459, 467.

"The sole owner and operator of oil properties clearly has a capital *investment in the oil in place,* if anyone has, and so is taxable on the *gross proceeds of production* and is granted a deduction from gross income *as compensation for the consumption of his capital.* See Burnet v. Harmel, supra, at 107-108; Helvering v. Clifford, No. 383, October Term, 1939. By an *outright sale* of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his *situation the reasons for the depletion allowance.* 'The words "gross income from the property," as used in the statute governing the allowance for depletion mean gross income received from the operation of the oil and gas wells *by one who has a capital investment therein,*— not income from the sale of the oil and gas properties themselves.' Helvering v. Elbe Oil Land Co., 303 U. S. 372, 375-376.

"Other situations, falling between the two mentioned, have been put on one side or the other as the cases arose. The holder of a royalty interest—that is, a right to receive a specified percentage of all oil and gas produced during the term of the lease—is deemed to have '*an economic interest*' in the oil in place which is *depleted by severance.*

Palmer v. Bender, 287 U. S. 551, 557; Murphy Oil Co. v. Burnet, 287 U. S. 299; Burnet v. Harmel, 287 U. S. 103. See Lynch v. Alworth-Stephens Co., 267 U. S. 364. *Cash bonus payments, when included in a royalty lease, are regarded as advance royalties,* and are given the same tax consequences. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Co. v. Burnet, 287 U. S. 299; Bankers Pocahontas Coal Co. v. Burnet, 287 U. S. 308. Compare Helvering v. Elbe Oil Land Co., 303 U. S. 372, 375. * * *

"Thomas v. Perkins, 301 U. S. 655, relied upon by petitioners, presented the issue whether the right to oil payments—that is, the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced — *should be treated for tax purposes like the right to oil royalties* or *like the right to cash payments upon a sale.* In that case, the assignment of lease provided for payments in oil *only without the reservation of a royalty interest.* The question was whether the *assignees'* gross income should include moneys paid to the assignors by purchasers of the oil. We stated (p. 659): 'The granting clause in the assignment would be sufficient, if standing alone, to transfer *all the oil* to the assignee. It does not specifically except or exclude any part of the oil. But it is qualified by other parts of the instrument. The provisions for payment to assignors in oil only, the absence of any obligation of the assignee to pay in oil or in money, and the failure of assignors to take any security by way of lien or otherwise unmistakably show that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and

saved up to an amount sufficient when sold to yield $395,000.' Under these circumstances, the moneys received by the assignors from the sale of the oil *were deemed not to be income to the assignees.* See also Palmer v. Bender, 287 U. S. 551.

"The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of the oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. *Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years,* and permits of a simple and convenient allocation between lessor and lessee of both the gross income derived from production *and the allowance for depletion.* Compare Burnet v. Harmel, 287 U. S. 103, 106-107. Accordingly, this Court in Thomas v. Perkins decided that the provision in the lease for payments solely out of oil production should be regarded *as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments,* and should be given the same tax consequences *as a provision for oil royalties.* The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type. See Palmer v. Bender, 287 U. S. 551, 555-557; Burnet v. Harmel, 287 U. S. 103, 111." (Italics ours).

Let us now apply the principles of law, announced by this Court in the *Anderson case,* supra, to the facts in

petitioner's case, and determine into which of the following classes petitioner's case falls.

CLASS ONE: In the *Anderson case*, this Court said:

> "*By an outright sale of his interest for cash*, such an owner converts the form of his capital investment, *severs* his connection with the *production* of oil and gas, and the income derived from *production*, and thus renders inapplicable to his situation the reasons for the depletion allowance." (Italics ours).

Certainly petitioner's case does not fall in "Class One"—hence is not governed by the rule which is applicable thereto—because there was *no outright sale* by petitioner, of its entire interest for cash, nor a *severing* of its connection with *production* of oil and gas, and the "*income derived from production.*" On the contrary, petitioner reserved and retained, in the sale to the Atlantic Company, one-half of its former interest in the oil and gas in place, and the *production* therefrom, until it received $1,200,000.00, at which time it was provided title to said reserved interest should ipso facto pass to the Atlantic Company.

CLASS TWO: In the *Anderson case* this Court said:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties and are given the same tax consequences" — Again,
> * * *
>
> "Accordingly, this court, in Thomas v. Perkins, decided that the provision in the lease for payments solely out of oil production should be regarded *as a reservation from the granting clause of an*

amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties." (Italics ours).

Petitioner submits that its case falls in, and is governed by the rule announced in "Class Two," for, if, as stated above, *an oil payment* "should be given the same tax consequences as a provision for *oil royalties*", then an *oil payment* should be treated as a form of "*oil royalty*" for tax purposes; and, since a *cash bonus* payment, where a *royalty* is retained is subject to the 27½ per cent statutory depletion allowance, it follows that a *cash bonus* payment, where *an oil payment* is retained (having the same tax consequences as the reservation of an *oil royalty*), is likewise subject to the 27½ per cent statutory depletion allowance.

* * * * *

Petitioner respectfully submits that when all of the foregoing expressions of the Supreme Court of the United States are considered, the conclusion is inescapable that the reservation by Petitioner of one-half of its interest in the oil and gas leases transferred to the Atlantic Company until it received from the sale of oil and gas produced from said one-half interest the sum of $1,200,000.00, free of expense of production or operation, constituted an economic interest or overriding royalty retained by petitioner in the oil, gas and minerals in and under the ground covered by the leases in question, and that the payment to and receipt by petitioner of $212,581.77 from the Atlantic Company represented, in law, a payment in advance for oil then in the ground, to be produced in the future, in the same

way and manner that a cash bonus paid to the land owner for an oil and gas lease wherein an economic interest (royalty) is reserved to the land owner represents an advance payment made to him for royalty oil to be produced in the future, regardless of whether any oil or gas may or may not thereafter be actually produced. *(Herring v. Commissioner*, 293 U. S. 322.)

While not controlling, petitioner calls attention to the decision of the Supreme Court of Texas in the case of *State v. Quintana Petroleum Co.*, (133 S. W. (2d) 112) decided November 22, 1939, which holds that the reserved interest in oil produced from land until a stipulated amount of money is realized therefrom (in other words "an oil payment") is no different in nature from the ordinary one-eighth royalty interest. The Supreme Court of Texas, in its opinion, said:

> "The 7/32 interest reserved in the lease executed by O'Connor is not different in nature from the ordinary 1/8 royalty interest. The only difference is that it may not endure for as long a period as does the royalty reserved without limitation. Associate Justice Greenwood's opinion in the Hogg-Sheffield case does make mention of the fact that the ordinary 1/8 royalty continues throughout the duration of the leasehold estate, a determinable fee, which may be perpetual, and is therefore a fee simple interest in land. The opinion, however, contains nothing to suggest that a royalty interest, subject to a limitation which may cause it to terminate before the expiration of the leasehold estate, is not an interest in land. * * *
>
> "This court by its refusal of application for writ of error evidenced its approval both of the

judgment and of the determination of the principles of law declared in the opinion of the Court of Civil Appeals in Sheppard v. Stanolind Oil & Gas Co., 125 S. W. (2d) 643, 649. * * *

"In demonstrating that such reserved right to payment out of production is essentially the same as the royalty ordinarily reserved, Chief Justice McLendon, writing the opinion in this case, said:

> 'Inherently, therefore, these sums possess every characteristic of the royalty payments, save only that the former are limited to the quantity of oil actually produced up to the amount equal in value to the stated sums. Both are conditional absolutely upon the fact of production, and both are limited to the amount of production; the former continuing so long as there is production, the latter ceasing when the production reaches the stated amount. For all practical purposes, and viewed in the light of every practical consideration, the interest of the State in the production of 1/6 of 5/6 of the oil, up to the full amount of the stated sum, is essentially and actually in nowise different from its interest under its retained royalty'."

* * * * *

Petitioner respectfully submits that if the following language, contained in the opinion of this Court in *Palmer v. Bender*, (287 U. S. 551, 558), means what it says, then no distinction can be drawn between a landowner's right to the 27½ percent depletion allowance on a cash bonus, received on an oil and gas lease executed by him as lessor, wherein a royalty is retained, although no oil is produced during the tax-

able year from the land covered by the lease—hence, no depletion actually occurs—(*Herring v. Commissioner*, 293 U. S. 322), and the right of a lessee, who transfers his interest in a lease to a third party, reserving an overriding royalty to be paid out of future production free of expense to him, to the 27½ percent depletion allowance on a cash bonus received in the sale. The language referred to in *Palmer v. Bender*, supra, found at page 558, is as follows:

"In the present case the two partnerships acquired, by the leases to them, complete legal control of the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired *an economic interest* in it which represented their capital investment and was subject to depletion under the statute. *Lynch v. Alworth-Stephens Co.*, supra. When the two leases transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, *an economic interest* in the oil, in place, identical with that of a lessor. *Burnet v. Harmel*, supra; *Bankers Pocahontas Coal Co. v. Burnet*, supra. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases

until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletiion according to the peculiar conditions in each case."

In the case now before the Court, petitioner was a lessee. It transferred to the Atlantic Company its undivided interests in eleven oil, gas and mineral leases, and all personal property, reserving and retaining one-half of its former fractional interests in said leases until it received $1,200,000.00 from the sale of oil, gas and minerals therefrom, free of production or operation expense. (Bd. Tax Appeals Findings of Fact, Tr. 100). Petitioner submits that, under the language above quoted in the *Palmer v. Bender* case, this reservation constituted "an economic interest in the oil in place identical with that of the lessor" and, as a result, Roeser & Pendleton, Inc., was entitled to the statutory 27½ percent depletion allowance on the $212,581.77 cash bonus received by it in the same manner that Herring was permitted the 27½ percent depletion allowance on the cash bonus received by him as a lessor, notwithstanding no oil was produced during the taxable year from the land covered by the lease. (*Herring v. Commissioner*, 293 U. S. 322).

It is well settled, under repeated decisions of this Court, that a cash payment or bonus, received by an owner in the transfer of oil and gas rights, is income. In *Work v. Mosier*, 261 U. S. 352, this Court said:

> "It was really part of the royalty or rental in a lump sum or down payment. We do not see how it

can be classified as anything else. It was income from the use of the mineral resources of the land. Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine."

The case of *Burnet, Commissioner v. Harmel* (287 U. S. 103), decided November 7, 1932, called for a decision of whether a cash bonus, as distinguished from royalties, should be treated as a gain from the sale of capital assets, or as ordinary income. In deciding the case this court said:

> "The court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. * * * But bonus payments to the lessor have been deemed to be subject to depletion allowances under Section 214a (9), Revenue Act of 1924, by Article 216, Treasury Regulations 65, as well as under earlier acts. * * * Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production." See Work v. Mosier, 261 U. S. 352, 357-358."

In the case of *Murphy Oil Co. v. Burnet*, (287 U. S. 299), decided December 5, 1932, this Court said:

> "We think it no longer open to doubt that when the execution of an oil and gas lease is followed

by production of oil, *the bonus and royalties paid to the lessor* both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under paragraph 234. See Burnet v. Harmel, supra. This is obvious where royalties alone are insufficient to return the capital investment. *A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for a reasonably anticipated production of oil on the leased premsises, would deny the 'reasonable allowance for depletion' which the statute provides.* The harsh operation of such a rule with respect to taxpayers generally is apparrent and is emphasized by the opportunist character of petitioner's argument here. The rule for which it contends can operate to its advantage only if it fortuitously escapes payment of any tax on the bonus payments, which it insists shall be treated as income without the deduction of any depletion allowance." (Italics ours.)

* * * * *

The proposition announced above, in Italics, is equally applicable here; to paraphrase it: a distinction between the $1,200,000.00 retained oil and gas interest, in place, and the $212,581.77 cash payment or bonus, forming the basis of the sale made by petitioner to the Atlantic Company, "which would allow a depletion deduction on the former, but tax the latter in full as income, when received, making no provision for a reasonably anticipated production of oil on the leased premises, would deny the 'reasonable allowance for depletion' which the statute provides."

Again petitioner points out that, under the decision of this court in *Palmer v. Bender*, 287 U. S. 551, in the absence of an *outright sale*, referred to in *Anderson v. Commissioner*, 310 U. S. 404, petitioner was entitled to a *return* through the statutory 27½% depletion allowance, of *its invested capital*, based upon discovery value, in the oil and gas properties sold by it to the Atlantic Company, and, if petitioner elected, as it did, to have the Atlantic Company pay it $212,581.77 cash, in anticipation of future production of that amount from the retained minerals, in place (this cash payment representing a pro tanto return to petitioner of its invested capital, based upon discovery value) petitioner was entitled to the statutory 27½% depletion allowance upon the $212,581.77 cash payment received.

* * * * *

Two further observations and petitioner will conclude this argument:

In the *Fleming Case*, 82 F. (2d) 324, at page 327 the Fifth Circuit Court of Appeals, in its opinion, said:

> "While the contract was phrased as though the lease and all the oil were sold, as though the proceeds were to be paid back to the seller, the real essence of the transaction was that the lease was sold, and all the oil except that whose proceeds were to come to the selling taxpayer. * * * The thing sold for the cash consideration was the lease and all the oil except that so reserved."

Based upon the conclusion just quoted, the Fifth Circuit Court of Appeals proceeded to hold:

> "We think the Board rightly held as to the transactions herein in question that *part* of the income arose from a sale of a capital asset, and was not subject to a depletion allowance, and that *part* of it arose from the operation of the oil wells and was so subject." (Italics ours).

Petitioner construes the above reasoning of the Fifth Circuit Court of Appeals to mean that an *outright sale* was made of the lease and all of the oil in place, except the retained portion, and, as to the *cash received from the outright sale*, it was not subject to the statutory 27½% depletion allowance, because it constituted a sale of a capital asset.

Again petitioner repeats that while this is an ingenious, it is of the same character referred to by this court in *Murphy Oil Co. v. Burnett*, 287 U. S. 299, as an "opportunist argument."

Mr. Justice Murphy, in his very clear opinion in *Anderson v. Helvering*, 310 U. S. 404, stated what constituted an *outright sale* of an oil property in these words:

> "By an *outright sale* of his interest for cash, such an owner converts the form of his capital investment, *severs* his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance." (Italics ours).

Petitioner submits that, under Justice Murphy's definition of what constitutes an "*outright sale*" of an oil property, the ingenious but tortured reasoning, used by the Fifth Circuit Court of Appeals, in its opinion

in the *Fleming Case*, supra, cannot be sustained, but must be rejected. In fact, it was rejected by the United States Court of Claims in *Heep Oil Corp. v. United States*, 32 F. Supp. 763, decided May 6, 1940.

Hence, again, no matter what turn the argument takes, one is relentlessly driven back to the fundamental truth, expressed in this Court's opinion in the *Palmer v. Bender Case*, 287 U. S. 551, in these words:

> "Lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has *retained a right to share in the oil produced. If so, he has an economic interest in the oil, in place, which is depleted by production.*" (Page 557) * * *
>
> "The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of discovery, rather than at its original cost. The benefit of it accrues to the discoverer if he operates the well as owner or *lessee*, or if he leases it to another. It would be an anomaly if that policy were to be defeated and all benefit of the depletion allowance withheld *because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another. The bonus received by the Smitherman partnership was a return pro tanto of the petitioner's capital investment in the oil, in anticipation of its extraction*, resulting in a corresponding diminution in the unit depletion allowance upon the royalty oil as produced." (pages 558-559).

So, in petitioner's case, the $212,581.77 received by petitioner in the sale made to Atlantic Company, constituted "a return pro tanto of petitioner's capital investment in the oil, in anticipation of its future extracton, thus entitling petitioner to the statutory 27½% depletion allowance.

* * * * *

Only one further reason for denying petitioner the benefit of the "economic" interest rule, under this Court's decision in *Palmer v. Bender*, supra, requires answer. The Fifth Circuit Court of Appeals in the *Fleming Case*, 82 F. (2d) at page 327, said:

> "In Palmer v. Bender, however, the transferor reserved an *additional royalty*, and so was in reality a sublessor, and the cash paid him could more readily be treated as a bonus or advance royalty." (Italics ours).

Petitioner submits that the reason above assigned by the Fifth Circuit Court of Appeals, for not applying to the *Fleming Case*, 82 F. (2d) 324, the "economic interest" depletion rule, approved in *Palmer v. Bender*, 287 U. S. 551, is indeed strained. It so happened in the *Palmer v. Bender Case* that the lessees, in transferring to the Ohio Oil Company a part of the leased property, on which the producing well was located, in addition to requiring the Ohio Oil Company to make a cash payment (called a "cash bonus"), and to make a future payment "out of one-half of the first oil produced and saved," to the extent of $1,000,000.00, retained an "excess royalty" of one-eighth of all the oil produced and saved, whereas, in the *Fleming Case*, and in petitioner's case, only a cash payment and a future pay-

ment out of a stipulated interest in the oil and gas, produced and marketed in the *Fleming Case*, and in place, in petitioner's case, was provided for.

However, as above suggested by petitioner, a construction of this Court's opinion in *Palmer v. Bender*, supra, which limits and restricts its application to cases where an *excess royalty is provided for*, in addition to the cash payment, and the retention by the seller of a stipulated interest in the oil and gas in place, and an equivalent share in the oil and gas produced, until a stated amount of money is received by the seller, is not only narrow but constitutes a strained construction of this Court's holding in the *Palmer v. Bender Case*, supra.

Petitioner submits that this Court never intended that the word "royalties," used in its opinion, should be confined and limited to a *technical royalty*, but, on the contrary, should embrace and include any character of interest in the minerals reserved and retained by a seller, and especially where, as in petitioner's case, the purchaser was required to pay the production and operation expense. As a matter of fact, this would in itself make such retained interest a royalty. So that this court may have before it what was said concerning royalties in its opinion in the *Palmer v. Bender case*, supra, the following paragraph is copied:

> "When the two *lessees* transferred their operating rights to the two oil companies, whether they became technical sublessors or not, *they retained by their stipulation* for royalties, an economic interest in the oil, in place, identical with that of a lessor. Thus, throughout their changing relation-

ship with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships, and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time, from the date of the leases until complete extraction, would have resulted in loss to the partnerships. *Such an interest*, is we think, included within the meaning and purpose of the statute permitting deduction, in the case of oil and gas wells, of a reasonable allowance for depletion according to the peculiar conditions in each case." (287 U. S., at page 558).

"The statute makes effective the legislative policy, favoring the discoverer of oil by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost. The benefit of it accrues to the discoverer if he operates the well as owner or lessee, or if he leases it to another. It would be an anomaly if that policy were to be defeated and all benefit of the depletion allowance withheld, because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another.

"The *bonus* received by the Smitherman partnership was a return *pro tanto* of the petitioner's capital investment in the oil, in anticipation of its extraction, resulting in a corresponding *diminution in the unit* depletion allowance upon the royalty oil *as produced.* Compare Murphy Oil

Co. v. Burnet, supra." (287 U. S., at pages 558, 559).

As indicating that this Court, in *Palmer v. Bender*, supra, meant to include in the term "royalty" the seller's retained interest in the oil and gas in place, regardless of whether same constituted a technical royalty, an oil payment, or something else, petitioner quotes the following paragraph from the decision of this court in *Thomas v. Perkins*, 301 U. S. at page 661:

> "If Palmer had retained *no interest* in the oil he would have been entitled to *no deduction* on account of depletion. *Ownership was essential.* The assignee was not entitled to income from Palmer's share of the oil nor to deduct from the income it received from its own interest any part of the depletion allowance that was attributable to Palmer's interest."

Petitioner submits that it is crystal clear that this court in *Palmer v. Bender*, supra, *Thomas v. Perkins*, supra, and *Anderson v. Helvering*, supra, did not intend to restrict the right of a seller of an oil and gas property to a return of his capital investment, either actual or based upon discovery value, to instances where the seller, in addition to a cash payment and a retention of a stipulated interest in the oil and gas in place, reserved an interest in a *technical royalty;* But, on the contrary intended by the use of the term "royalty" to include every situation where a seller in making a sale, retained an interest in the oil and gas in place, or provided for payments to be made to him solely from the production of oil and gas. Expressed in another way, the right of an owner of an oil and

gas property to a return of his invested capital is not limited to cases where the seller reserves an interest in the landowner's royalty, in addition to retaining an interest in the oil and gas in place and the production arising therefrom (this Court so held in *Thomas v. Perkins*, 301 U. S. 655). This conclusion is in harmony with the following statement of this court in *Helvering v. Elbe Oil Company*, 303 U. S. 372, at page 375:

> "We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the Honolulu Company. See Helvering v. O'Donnell, ante, p. 370. In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a 'bonus' in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. Such payments are made to the recipient as a return upon his capital investment in the oil or gas in place."

It is pertinent to here state that this court granted a petition for certiorari in the *Helvering v. Elbe Oil Co. case*, supra, "Because of an asserted conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. Fleming*, 82 F. (2d) 324. (See statement in this court's opinion, 303 U. S. at top page 374.) However, upon a review of the facts involved in the *Elbe Oil Company case*, this court held that the cash payments stipuatel to be made by the buyer to the seller were not coupled with any reten-

tion by the seller of any interest in the oil and gas in place; hence the transaction there constituted an absolute sale of all of the properties in question, including all the oil and gas in place, with no retention by the seller of any interest therein.

Petitioner respectfully submits that if this court granted a petition for certiorari in the *Elbe Oil Company case* to determine an asserted conflict with the decision of the Fifth Circuit Court of Appeals in the *Fleming case*, 82 F. (2d) 324, it is reasonable for petitioner to request that its petition for certiorari in this case be granted, to resolve an asserted conflict between the decision of the Fifth Circuit Court of Appeals in the *Fleming Case*, 82 F. (2d) 324, and the decision of the United States Court of Claims in the *Heep Oil Corporation case*, 32 F. Supp. 762, as well as to resolve a conflict between the decision of said Circuit Court of Appeals in the *Fleming case*, supra, and of this court in the *Palmer v. Bender case*, supra.

Petitioner cannot understand how anyone can read this Court's opinion in *Palmer v. Bender*, 287 U. S. 551, and in *Anderson v. Commissioner*, 310 U. S. 404, and fail to be indelibly impressed with the following *fundamental and controlling principles* there announced.

1. The right of an owner of oil and gas in place, who is entitled to share in its production, to have returned to him his capital investment, either actual, or upon a discovery value, as he may elect, through the medium of the statutory depletion allowance; and,

2. Where the owner sells his property, for a stipulated amount of cash, and at the same time retains a

stated interest in the oil and gas in place, until an agreed amount of money is received therefrom, he has such an "economic interest" in the minerals, represented by his capital investment in the oil and gas, in place, as entitles him not only to a *return of his capital investment,* through the statutory depletion allowance on the retained interest in the minerals in place, but as well, the cash payment or bonus received, because, as stated by this Court in *Palmer v. Bender*, 287 U. S. at page 559:

> "The bonus * * * was a return *pro tanto* of the petitioner's capital investment in the oil, in anticipation of its extraction."

It is not too much to state that this Court never intended to have its holding in the *Palmer v. Bender, Case* confined and limited to instances where the seller retained an *excess royalty* in addition to a retained interest in the oil and gas in place. This indeed, would be a narrow construction, and would constitute an open invitation to owners of oil properties in making a sale for cash and a retained interest in the oil and gas, in place, to also reserve an inconsequential excess royalty, say 1/10,000th, so as to be assured that, by so doing, they would bring themselves within the narrow confines of the *Palmer v. Bender Case*, with respect to taking the statutory depletion on the cash received.

* * * * *

On the other hand, if the Fifth Circuit Court of Appeals, has correctly construed this Court's holding in the *Palmer v. Bender Case*, as requiring the retention by the seller of *a technical royalty interest*

in the minerals, in place, in order to be entitled to the statutory depletion allowance on the cash payment received by the owner, in making a sale of his oil property, then petitioner submits that the interest retained by it, in the oil and gas in place, in the sale made by it to the Atlantic Company, constituted *an overriding royalty*, because it was not charged with any expense of production, or operation. In fact, a typical division order, under which petitioner received payment for its reserved interest, referred to same as "ORI" (overriding royalty interest). (R. 88).

Furthermore, as hereinbefore pointed out, while not controlling, the Supreme Court of Texas, in *State v. Quintana Pet. Co.*, 133 S. W. (2d) 112, has held that a reserved interest in oil produced under a lease until a stipulated amount of money is paid, is no different in nature from the one-eighth royalty interest, and we are confident that, if this point is pertinent to a proper decision of the question presented by this petition for certiorari, this court will hold likewise.

CONCLUSION

Upon a considration of this petition for certiorari, this Court is chiefly concerned in determining:

First: Whether the Circuit Court of Appeals, in this case has rendered a decision in conflict with the decision of another Circuit Court of Appeals on the same matter? (Rule 5-b). It has, assuming that the decisions of the United States Court of Claims are regarded by this Court as possessing equal force with those of the Circuit Court of Appeals, for in the case

of *Heep Oil Corp. v. United States*, 32 F. Supp. 762, the Court of Claims not only declined to follow, but held contrary to, the Fifth Circuit Court's opinion in the *Fleming Case*, 82 F. (2d) 324, upon which its decision in this case is predicated. A clear conflict is therefore presented.

Second: Whether the Circuit Court of Appeals, in this case, has decided a Federal question in a way probably in conflict with applicable decisions of this Court? (Rule 5-b). It has, by misconstruing and not applying the "economic interest" depletion rule approved by this Court in the case of *Palmer v. Bender*, 287 U. S. 551, as explained in *Thomas v. Perkins*, and *Anderson v. Commissioner*, 310 U. S. 404.

Third: Whether there still remains undecided a conflict between the decision of the Ninth Circuit Court of Appeals, in the *Elbe Oil Company Case*, 91 F. (2d) 127, decided by this Court, in 303 U. S. 372 by distinguishing the facts—and the decision of the Fifth Circuit Court of Appeals in the *Fleming Case*, 82 F. (2d) 324, which was adopted and followed in petitioner's case, upon the legal question, involved in both cases, to-wit: whether a seller is entitled to statutory depletion allowance on a cash payment received, where the seller retains an "economic interest" in the oil and gas, in place, until a stipulated sum is paid from production. The Ninth Circuit Court of Appeals, in the *Elbe Oil Company Case*, supra, held he *was* entitled to the depletion allowance on the cash payment, and the Fifth Circuit Court of Appeals, in the *Fleming*, the *Laird* cases, and in petitioner's case, held he was *not*. The Supreme Court did not decide this conflict, present-

ed in the *Elbe Oil Company Case*, 303 U. S. 372, notwithstanding certiorari was granted on the ground of such asserted conflict. (See Court's comment, 303 U. S., top p. 374). As stated, this Court held the facts in the *Elbe Oil Case* were different from those in the *Fleming Case*. Hence it was not necessary for this Court to decide the conflict.

Petitioner calls attention to the case of *Berry Oil Co. v. United States*, 25 Fed. Supp. 97, decided by the Court of Claims on January 9, 1939, in which this court denied certiorari on May 22, 1939. The facts in this case were quite like those in Elbe Oil Company, 303 U. S. 372, in that both presented situations where the seller retained no interest in the oil and gas in place, until a stipulated sum was paid therefore by production. In both cases, there was an *outright sale, with no reservation of minerals.* Hence, the denial of certiorari by this Court in the *Berry Oil Company case*, 25 Fed. Supp. 97, has no bearing upon what action this Court should take in petitioner's case.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, that the Petition for Writ of Certiorari should granted, and upon final hearing, the decree of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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